

The PERAC Financial Bulletin

Financial Market Review, Fourth Quarter 2006



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In early summer, after a lackluster first half of the year, investors began to sense that the Federal Reserve was close to achieving the elusive goal of a “Goldilocks” economy, one that is growing fast enough to foster impressive corporate profits but not rapidly enough to fan fears of inflation. The result of this increasing investor optimism, at a time when the world was awash with financial liquidity, was a “best of all worlds” investment scenario where every major asset class and sector posted positive returns for

the year. Equities had their second best year of the decade in response to strong profit growth while bonds held their own as a result of lowered inflation expectations.

Equity Market

Thanks to the second half rally, the stock market enjoyed its fourth consecutive year of gains and the magnitude of those gains surprised most prognosticators. A significant fall in energy prices served to cool inflationary fears while bolstering consumer spending. The Fed

halted its 2½ year program of raising short-term interest rates. Amid fair stock market valuations and the abundance of relatively cheap money, heavy stock buybacks and very active private equity funds contributed to a sense of unstoppable market momentum. Institutional investors who awaited a market correction never got their opportunity to jump in at cheaper levels.

As seen in the accompanying table, the broad stock market indices generally rose 6-9% during the

Chart 1

S&P 500 in 2006: After a Flat First Half, a Robust Second Half

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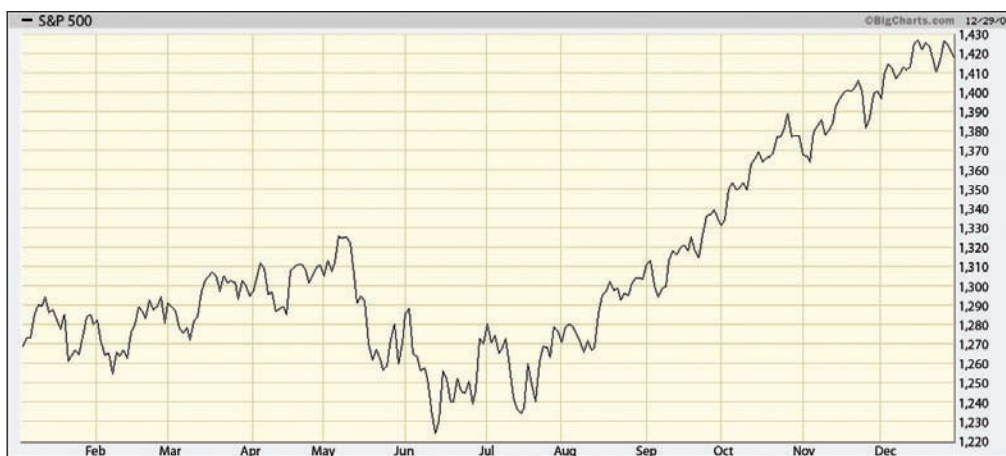


Chart 2

S&P 500, Five Years: After 2002, Four Straight Positive Years

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fourth quarter. For the year, the total return of the Dow Jones Wilshire 5000 was 15.9%. The S&P 500 (large cap) index was up 15.8%, although (as seen in the accompanying graph) it is still about 7% below its record high of March 2000. The technology-laden NASDAQ composite lagged, up only 9.5% for the year.

Perhaps the year's biggest surprise was that small caps outperformed large caps for the eighth consecutive year. As it soared to a

new record high, the Russell 2000 outpaced the S&P 500 by 2.6% in 2006. Over the trailing 3 and 5-year periods, the respective annualized return differentials in favor of small caps were 3.1% and 5.2%.

Investors had also expected that 2006 would be the year that growth stocks finally reversed the lengthy run of out-performance by value. Alas, this wasn't to be, according to the Russell broad market indices, as value outperformed growth by almost 13% in 2006, and by

annualized differentials of 8%, 8%, and 6% respectively, over the trailing 3, 5, and 10-year periods.

Among the S&P 500's ten market sectors, telecommunications (+32.1%) and energy (+22.2%) led the way while information technology (+7.7%) and health care (+5.8%) lagged. Among major individual stocks, General Motors was the surprise leader, surging 58% off its depressed year-end 2005 level, while Intel, the leading semiconductor manufacturer, saw its

Chart 3

S&P 500, Ten Years: Despite Four Up Years, Still Below 2000 Peak

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Chart 4

S&P 500 vs. NASDAQ, Ten Years: Except For the "Bubble" Years, About Even

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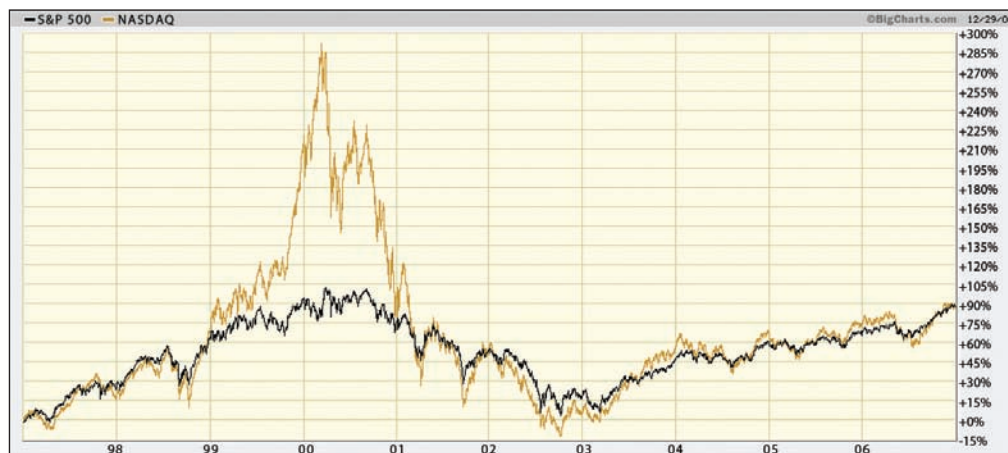
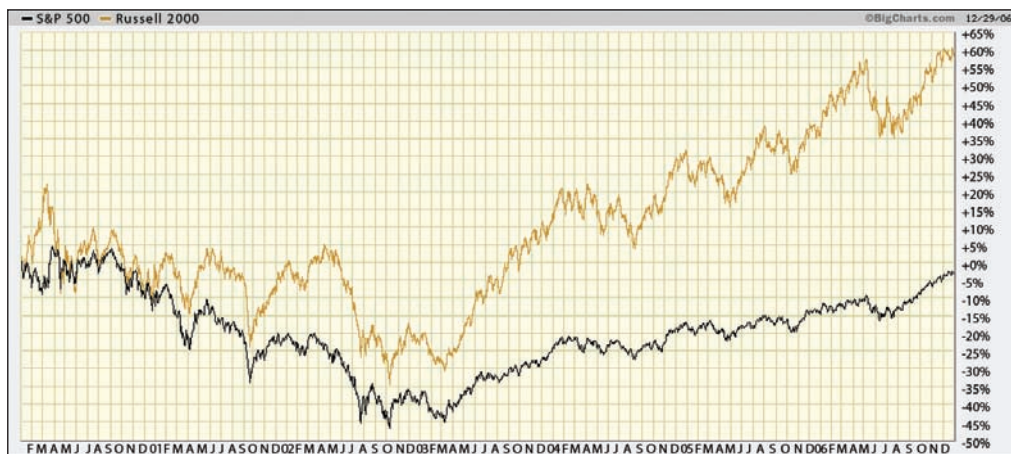


Chart 5

S&P 500 vs. Russell 2000: All This Decade, Small Caps Rule

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stock fall 18% as the company faced intense competitive pressure within its industry. WalMart and Home Depot both registered declines of about 1% while Cisco (+60%), Exxon Mobil (+36%), and AT&T (+46%) had above-average gains.

Another trend that did not fade away during 2006 was the strong performance of international equity markets. Reflecting not only strong overseas earnings but also the effect of a weaker dollar (for example, the dollar weakened by 10.3% versus the Euro), the MSCI-EAFE Index was up 10.4% for the fourth quarter and 26.3% for the year in dollar terms. Reflecting the effect of currency translation, the respective gains were only 7.0% and 16.5% in local currency terms. In addition to the out-performance of 10.5% in 2006, MSCI-EAFE has outperformed the S&P 500 by 9.5% and 8.8% on an annualized basis for the trailing 3 and 5-year periods. Emerging markets recovered from an early correction to once again post impressive returns, up 17.6% for the quarter and 32.2% for the year. Annualized returns have been 30.5% and 26.6% over the past 3 and 5-year periods.

European markets benefited from continued corporate restructuring and strong growth, with much of

the growth being export-oriented. China and India were also fast growers, both in their internal economies and in trade. Russia, Brazil, and Venezuela were helped by trends in the commodity markets, while Latin American markets benefited from economic and political stability. The major disappointment in international markets was Japan, where economic growth and market appreciation both sputtered.

Fixed Income

The headline in the fixed income markets was that, after 17 rate increases raised the Fed funds rate from 1.0% to 5.25%, the Fed halted its tightening program in June. 2006 was also a year of record issuance in both the investment grade corporate bond market and in the high yield market as companies took advantage of rates that were still historically low to fund acquisitions, leveraged buy-outs, and re-financings. Longer-term Treasury rates remained low and indeed lower than the Fed funds rate and other short-term rates in a trend (termed an “inverted yield curve”) that is often seen as a harbinger of recession. Nevertheless, in somewhat of a paradox, the yield differentials between Treasuries, corporate securities, and high yield bonds actually narrowed further in 2006, a trend that usually signi-

fies optimism over the economy.

The ten-year Treasury note began the year at 4.39% and was as high as 5.25% in June, but yields generally declined over the second half after the Fed signaled its intentions. The yield was as low as 4.47% in early December but fell back to 4.71% at year-end. (Bond prices move inversely to yields.)

The Lehman Brothers Aggregate Index rose 4.3% for the year; among its components, mortgage-backed bonds and corporate bonds performed better than Treasuries. The Merrill Lynch High Yield Index enjoyed impressive performance of 11.6% as yield spreads narrowed and default rates remained low. Over the past five years, high yield has outperformed the Lehman Aggregate by 4.4% annually.

Other Asset Classes

While the slump in the residential housing market has been the subject of considerable media focus, the surprising strength in the commercial real estate market has received less fanfare. Massive financial liquidity amid a generally healthy economy has contributed to the robust condition of this asset class. Vacancies for office space are the lowest since 2001 and the price per

square foot of space rose 17% last year, according to one survey. Not only have prices paid been surging for office space but they have also been rising for industrial and retail space. Reflecting these factors, publicly-traded equity Real Estate Investment Trusts returned an astonishing 35.1% in 2006. The annualized 3, 5, and 10-year returns for this sector have been 25.9%, 23.2%, and 14.5%. The year-end NCREIF Index returns for private property investment are not yet available, but the annualized rate of return through the third quarter was 17.6%.

As previously noted, inexpensive stock valuations and cheap, abundant money have been the key to the completion of many leveraged buyouts and have contributed to boom times for the private equity business. Although conditions have improved, times have been less buoyant for the venture capital industry, where it is perceived that there is too much money chasing available deals, thereby raising the price and lowering expected returns from these deals. The still-lackluster market for initial public offerings has also had a negative effect. Both the number and dollar volume of venture-backed IPOs in 2006 were only about a quarter of the corresponding levels for 2000. The range of returns among alternative investments managers is always very wide and the publication of benchmark returns is significantly delayed. One-year returns through June 30, 2006 (nearly all the equity market's strength occurred in the second half of the year) indicated performance of 14-16% for venture capital and 23-26% for buyouts.

Returns were solid but unspectacular for hedge funds in 2006. Performance varies significantly

among the many distinct absolute return strategies and among managers, but early indications show aggregate hedge fund returns in the range of 11-13%, higher than those of bonds but lower than those of equities. In late summer, the industry suffered its largest individual meltdown since the Long Term Capital Management collapse in 1998 when Amaranth Advisors suddenly lost over \$6 billion, or about two thirds of its total assets, through speculative energy trading that went awry. Although a number of well-established funds of funds had invested in Amaranth, the fallout from this collapse was limited. The other major event from 2006 was a federal appeals court's invalidation of the SEC's plan to regulate hedge funds. Overall, the industry continued to grow, with up to \$1.4 trillion under management by some counts, with significant inflows from investors seeking returns uncorrelated with those of the major markets.

Looking Ahead

The markets entered 2007 with considerable momentum but also, as usual, with major uncertainties. Will the economy perform up to the optimistic expectations built into equity prices? Did 2006's strong second half "borrow" returns from 2007's first half? The stock market has advanced four consecutive years, but bull markets have rarely gone five years. Thanks in part to favorable weather, the price of oil was essentially unchanged from the beginning to end of 2006, but will these conditions last? How much longer will corporate profit growth outpace GDP growth? Lulled into a sense of complacency, the major equity market indices continue to exhibit the lowest levels of volatility in several years, but how much

longer will these conditions last?

As discussed here, all major asset classes, subclasses, and sectors had positive returns in 2006, but there was obviously a wide disparity in returns among all the categories. All retirement boards should have easily exceeded their target rates of return last year, but the extent to which they did so depended on their individual asset allocation and how their roster of investment managers performed.

As noted, last year saw the continuation of a number of investment trends and among them was the observation that the key to strong performance was to maximize portfolio diversification. In almost every instance, investments generally considered more risky outperformed their more conservative counterparts: small caps over large caps, international over domestic equity, emerging over developed markets, high yield over high grade bonds. Relatively illiquid asset classes such as real estate, alternative investments, and, to a lesser extent, hedge funds, all provided not only diversification but also attractive returns. Of course, in these nontraditional asset classes, it is particularly important to identify and gain access to the best possible managers.

As always, the PERAC investment unit is eager to offer technical assistance to retirement systems in any phase of their investment process—determining asset allocation, hiring investment managers, monitoring investment managers, and evaluating their performance. Give us a call!

TOTAL RETURNS | FOURTH QUARTER, 2006

INDEX	FOURTH QUARTER 2006	FULL YEAR 2006	FIVE YEARS 2002-2006 Annualized
US EQUITY MARKET			
Dow Jones Industrial Avg.	+ 7.40%	+ 18.30%	+ 6.60%
Standard & Poor's 500 (Large Cap)	+ 6.70%	+ 15.79%	+ 6.19%
NASDAQ Composite	+ 6.95%	+ 9.52%	+ 3.50%
Wilshire 5000 (Broad Market)	+ 7.32%	+ 15.88%	+ 7.65%
Standard & Poor's Mid-Cap 400	+ 6.99%	+ 10.32%	+ 10.90%
Russell 2000 (Small Cap.)	+ 8.90%	+ 18.37%	+11.39%
GROWTH VS. VALUE			
Russell 1000 (Large Cap) Growth	+ 5.93%	+ 9.07%	+ 2.69%
Russell 1000 (Large Cap) Value	+ 8.00%	+ 22.25%	+10.86%
Russell Midcap Growth	+ 6.95%	+ 10.66%	+8.22%
Russell Midcap Value	+ 8.50%	+ 20.22%	+ 15.88%
Russell 2000 Growth	+ 8.77%	+ 13.35%	+ 6.93%
Russell 2000 Value	+ 9.03%	+ 23.48%	+ 15.37%
INTERNATIONAL EQUITY			
M.S.C.I. - E.A.F.E.	+ 10.35%	+ 26.34%	+ 14.98%
M.S.C.I. - Emerging Markets	+ 17.60%	+ 32.17%	+ 26.59%
FIXED INCOME			
Lehman Brothers Aggregate Index	+ 1.24%	+ 4.33%	+ 5.05%
Merrill Lynch High Yield Index	+ 4.44%	+ 11.56%	+9.45%
REAL ESTATE			
NAREIT - Equity Real Estate Investment Trusts	+ 9.47%	+ 35.06%	+23.20%
NCREIF Property Index	+ 3.51%	+ 17.62%	NA
	(Q3)	(Trailing 12 months)	